No. 80-715

In the Supreme Court of the United States

OCTOBER TERM, 1980

UNITED GAS PIPE LINE COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

JEROME NELSON
Acting General Counsel

JEROME M. FEIT
Deputy Solicitor

STEPHEN R. MELTON
Attorney
Federal Energy Regulatory Commission
Washington, D.C. 20426

TABLE OF AUTHORITIES

Page

Cases:

FPC v. *Hope Natural Gas Co.*, 320 U.S. 591 5

Permian Basin Area Rate Cases, 390 U.S. 747 5

Powell v. *Washington Metropolitan Area Transit Commission*, 485 F. 2d 1080 5

Statute:

Natural Gas Act, Section 14, 15 U.S.C. 717m 2

Miscellaneous:

P. Garfield & W. Lovejoy, *Public Utility Economics* (1964) 2

In the Supreme Court of the United States

OCTOBER TERM, 1980

No. 80-715

UNITED GAS PIPE LINE COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

Petitioner contends that the court of appeals erred in affirming the determination of the Federal Energy Regulatory Commission in ratemaking proceedings that assigned a net cost of zero to the preferred stock component of petitioner's capital structure where the dividends paid by petitioner on its preferred stock were ultimately returned in full to petitioner.

1. In March 1974, Pennzoil Producing Company (Pennzoil) embarked on a series of financial transactions to disaffiliate ("spin-off") its then wholly-owned subsidiary, United Gas Pipe Line Company (United). In essence, the spin-off was accomplished as follows: First, United declared a dividend to Pennzoil of $100 million in cumulative preferred stock with an annual dividend rate of 9 ¾%. The next day, Pennzoil declared a dividend to its shareholders of all of United's common stock and simultaneously made a $15 million capital contribution to United.

The Commission ordered an investigation of these transactions pursuant to its authority under Section 14 of the Natural Gas Act, 15 U.S.C. 717m. The investigation led to hearings, settlement negotiations, and eventually to a settlement agreement which was approved by the Commission. Under the terms of the settlement, the preferred stock issued by United was to be cancelled and all funds paid by both parties (including the dividends paid by United on the preferred stock) were to be refunded. On December 30, 1975, the terms of the settlement were carried out. The upshot was that while United was now independent of Pennzoil, both United and Pennzoil were returned to the same financial positions that they had occupied before the spin-off.

Thereafter, in the rate proceedings at issue here, the Commission determined that United was not entitled to have its rate of return reflect the dividends it had paid on the preferred stock (Pet. App. C-12 to C-16). The cost of capital ordinarily is a crucial factor in arriving at a reasonable rate of return for regulated utilities.[1] Because the spin-off settlement resulted in the full refund of the preferred dividends, the Commission concluded that the net cost of the preferred stock to United was zero. Accordingly, in determining the rate of return to which United was entitled, the Commission assigned no cost to the preferred stock component of United's capital structure.

---

[1]"The *cost of capital* is the composite, weighted cost of the various classes of capital (debt, preferred stock, common stock, and surplus) used by a company. The weighting is done according to the proportion which each class of capital is of total capital. The reasoning behind the calculation of the cost of capital is that it will provide a return sufficiently large to maintain the financial integrity of the company and to allow the company to attract new capital when necessary." P. Garfield & W. Lovejoy, *Public Utility Economics* 123 (1964) (footnote omitted; emphasis in original).

The court of appeals affirmed (Pet. App. A-1 to A-26; 618 F. 2d 1127). After an exhaustive analysis, it concluded (Pet. App. A-26):

> It is unusual for the Commission to allow zero return on $100 million of a utility's capital. However, the spin-off settlement created an extraordinary situation. For reasons it deemed proper, Pennzoil, the preferred shareholder, agreed to return all dividends paid on its $100 million of preferred stock during a twenty-one month period. Capital is never cost-free in the absolute, but in this case it was cost-free to United, for Pennzoil bore its entire cost. The rates set by the Commission properly reflected this unusual circumstance. United will earn sufficient revenues, after operating expenses, to pay the interest on its debt and offer a suitable reward to its common equity holders. The Commission properly discharged its responsibility in allocating this singular benefit to the ratepayers.

2. As petitioner correctly recognizes (Pet. 4), this Court rarely reviews administrative agency proceedings establishing a rate of return for a regulated enterprise. There is no reason for the Court to depart from that policy here.

The dispute in this case is not over the basic principles governing rate proceedings. Instead, the only question is whether, in this unusual factual context, the Commission properly exercised its ratemaking expertise in excepting from United's rate of return the preferred stock dividends that United had paid out and that were subsequently refunded to it by Pennzoil. The Commission's determination was correct.

Petitioner argues (Pet. 6-7) that because the preferred stock derived from United's common equity accounts,the Commission should have computed the applicable costs for the preferred stock on the same basis that it computed

the costs for United's common equity. But, as both the court of appeals (Pet. App. A-13, A-23 to A-25) and the Commission (Pet. App. C-11 to C-12) observed, this approach ignores the substantially different risks and rewards associated with preferred, as opposed to common, stock. Preferred shareholders have a senior claim on corporate earnings and thus their investment is less risky than common equity investment. While preferred shareholders receive their reward almost exclusively from the stated dividend, common equity investors seek to profit both from dividends and from capital appreciation. Accordingly, "[t]he rate of return allowed on common equity must be sufficient to reward the investors' risk and to attract capital" (Pet. App. A-23). In contrast, the rate of return on preferred stock is computed by the Commission on the basis of the "embedded" costs, "allowing the cost net of gains and losses or expenses realized in connection with the security" (*id.* at A-25). In this case, United voluntarily converted $100 million of its assets into preferred stock and issued that stock to Pennzoil. The court of appeals therefore properly affirmed the Commission's decision to classify the $100 million as preferred stock in computing United's costs.

On the unique facts of this case, United cannot fairly claim to have been deprived of "a just and reasonable return on its total investment dedicated to public service" (Pet. 5). As the court of appeals pointed out (Pet. App. A-23):

> [I]t was within the informed discretion of the Commission, recognizing that the cost of $100 million in capital had been borne by Pennzoil and not by United, to order that the rates be set so that the consumers gain the benefit of United's low-cost capital, rather than letting United charge as much as would have been appropriate had that capital been acquired by United in the market and paid for at the market's rate.

Undeniably, a public utility is entitled to recover the costs of the various components of its capital structure; but it is not entitled to a rate of return that bears no relationship to its actual capital costs.[2] Under well-settled principles, where the "total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry * * * is at an end." *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944); *Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968). Those principles govern here.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

JEROME NELSON
Acting General Counsel

JEROME M. FEIT
Deputy Solicitor

STEPHEN R. MELTON
Attorney
Federal Energy Regulatory Commission

JANUARY 1981

---

[2] *Powell* v. *Washington Metropolitan Area Transit Commission*, 485 F. 2d 1080 (D.C. Cir. 1973), upon which petitioner relies (Pet. 7-8), is inapposite. That case holds that retained earnings constitute equity and are entitled to an equity return. It does not address the issue presented here—*i.e.*, the proper rate of return on preferred stock.